

State of Connecticut

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Hartford

January 31, 2014

Legislative and Regulatory Activities
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Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re: Docket ID OCC-2013-0016; Docket No. R-1466; FDIC RIN 3064-AE04
Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and
Monitoring

Dear Sirs:

Thank you for the opportunity to comment on proposed revisions to current capital rules to implement the Basel III Revised Liquidity Framework that were issued jointly by your agencies ("Agencies"). Specifically, I write to register concerns with the revisions as they relate to the exclusion of municipal securities from consideration as eligible liquid assets which large banks may hold in their portfolios to meet the Basel III liquidity requirements as well as the cash flow rate assumptions for public deposits.

As Treasurer of the State of Connecticut, I am responsible for the State's issuance of debt obligations and management of its \$20 billion debt portfolio. In addition, I serve as principal fiduciary of the State's \$28 billion Connecticut Retirement Plans and Trust Funds, as well as its \$5 billion Short-Term Investment Fund. In these capacities, I keep abreast of developments with the securities markets and, in particular, the municipal market.

I fully support the important, complex work of your three Agencies in promulgating rules to maintain the stability of our financial system, including implementation of the Basel III liquidity framework system and the requirements of the Dodd-Frank Act. However, I believe there is no merit to excluding all municipal debt from being considered as liquid assets, and any such wholesale exclusion will result in harm to state and local governments. I strongly urge you to include municipal debt as a high quality liquid asset in your implementation of the Basel III Rule. Municipal debt is liquid and historically, during periods of financial stress, has an excellent track record in comparison to other types of securities that have been included in the proposed list of highly liquid assets. I note that there is a separate requirement that a financial institution demonstrate that any eligible security is "liquid and readily marketable." I believe that this requirement would address any concern that a particular municipal security, or any particular corporate or sovereign debt security for that matter, is insufficiently liquid to be included even if the market as a whole is highly liquid.

Moreover, I am very concerned with the effects that this proposed exclusion will have on municipal securities in general. It will make the holdings of municipal debt by large banks less attractive and have a negative impact on the demand for municipal bonds, thereby increasing the cost of such debt for state and local governments. In addition, the availability of bank credit and bank direct purchase alternatives for state and local governments will likely decrease and grow more costly.

By way of background, under the proposal, large banks covered by the rule will be required to maintain a minimum liquidity coverage ratio, defined as the ratio of high-quality liquid assets (HQLA) to total net cash outflows. HQLA assets are grouped as Level 1 (primarily sovereign entity debt), Level 2A (primarily government-sponsored entity debt) and Level 2B (corporate debt and S&P 500 equities). In the notice of rulemaking, the Agencies jointly state:

The proposed rule likely would not permit covered bonds and securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities) to qualify as HQLA at this time. While these assets are assigned a 20 percent risk weight under the standardized approach for risk-weighted assets in the agencies' regulatory capital rules, the agencies believe that, at this time, these assets are not liquid and readily-marketable in U.S. markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA under this proposed rule. For example, securities issued by public sector entities generally

have low average daily trading volumes. Covered bonds, in particular, exhibit significant risks regarding interconnectedness and wrong-way risk among companies in the financial sector such as regulated financial companies, investment companies, and non-regulated funds.¹

At least three reasons would justify the Agencies' treatment of municipal securities as either Level 2A or Level 2B.

First, many public sector issues are either general obligation securities, backed by the taxing power of the issuer, or revenue bond obligations backed by broad-based revenue sources. While there have been well-publicized instances of a very few issuers in financial distress, on the whole, the vast majority of municipal securities exhibit much less risk and volatility than many of the other types of securities the Agencies propose to group with Level 2A or Level 2B, such as sovereign and corporate debt.

Second, securities issued by public sector entities tend to exhibit lower average daily trading volumes because trades are reported by individual maturities within an issue and investors tend to be long-term holders of these securities. Nonetheless, this does not mean that municipal securities are not liquid. For example, the State of Connecticut has over 4,000 individual CUSIP numbers associated with its general obligation debt. Even if there is low trading volume associated with, for example, a December 1, 2020, maturity of a particular issue, there are scores of other securities of the State with identical credit characteristics and with the same maturity. Connecticut's \$14 billion of general obligation debt is all rated the same, payable from the same source, and is thus homogeneous and liquid.

Third, securities of public sector entities are overwhelmingly of investment grade. As the Agencies note, an investment grade rating of securities of corporate issuers "is indicative of lower risk and, therefore, higher liquidity." Would not the same be true of municipal bonds? Indeed, data bears out that investment grade municipal securities have an overall higher daily volume than investment grade corporate bonds. Thus, it should be the case that securities of the State of Connecticut and its municipalities and agencies are given Level 2A treatment.

¹ Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 50 (Docket ID OCC-2013-0016) RIN 1557 AD 74; Federal Reserve System, 12 CFR Part 249, (Regulation WW; Docket No. R-1466), RIN 7100 AE-03; Federal Deposit Insurance Corporation, 12 CFR Part 329, RIN 3064-AE04; *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring*, as published in the Federal Register on November 29, 2013, 78 F.R. 71818, 71827.

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Finally, I recognize that certain types of municipal securities -- particularly auction and variable rate securities backed by bank credit facilities and bond insurance -- were problematic during the 2007 and 2008 financial crisis. However, those problems were a function of the flawed nature of auction rate securities and the uncertainty regarding the financial stability of the banks and bond insurers, and had nothing to do with the underlying creditworthiness of the state and local governments. This is proven out by the very strong liquidity and credit quality of the more traditional long-term, fixed rate obligations of public sector issuers during this same period.

In addition, I recommend the revision of the proposed cash outflow rate assumptions for public deposits. Specifically, the proposal would assign a 100 percent outflow assumption for "secured funding" deposits not collateralized by HQLA securities. This rate is considerably higher than the outflow assumptions -- limited to 40 percent -- assigned to unsecured deposits. This inconsistency should be remedied.

For all of the above reasons, I firmly believe the Agencies should afford municipal securities at least some HQLA treatment.

Should you have any questions, please feel free to call on me.

Sincerely,



Denise L. Nappier
State Treasurer